

Section 125 Cafeteria Plans Legal Issues

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Section 125 Plan Requirements

- Internal Revenue Code Section 125:
 - The only way to exclude health insurance payments from employee income
 - Allows employees to buy coverage in individual insurance market with pre-tax \$
 - If health insurance is the only benefit, plan can be called “premium only plan” (POP)
 - For purposes of tax code, these individual premium payments (“salary reduction”) are considered employer contributions

Section 125 Plan Requirements

- Revised proposed regulations published August 2007
 - Final regulations expected before the end of 2008
- Written plan document lists specific benefits and maximum amounts for which payroll deduction is allowed, employee eligibility, etc.
- In the case of individually purchased benefits, employers must verify that employee funds are used for qualified coverage (i.e. health insurance)
- Employee annual election = irrevocable
- Applies only to employees (not self-employed, partners, and certain small corporation shareholders)
- Failure to meet tax law requirements subjects employer and employees to tax liabilities

Non Discrimination Provisions

- Cafeteria plans cannot discriminate in favor of highly compensated individuals or key employees (defined in the regulations)
 - Eligibility – if all employees are eligible, cafeteria plan meets this test
 - Contributions – any employer contributions must be at same level for HCE and non-HCE
 - Benefits – actual use of cafeteria plan contribution or salary reduction cannot favor HCEs. (Final regulations may clarify application to POP)

Application of other federal laws:

COBRA

- Because even employee-only premium payments are considered to be “employer contributions,” these cafeteria plans are considered “group health plans” under COBRA
- COBRA allows employees (of firms with 20 or more workers) leaving group coverage to stay in the group for 18 months (paying the full premium)
 - Continuation authority is irrelevant to individually purchased health insurance, but would permit employees to pay premium for the individual coverage under cafeteria plan of a new employer during insurance eligibility waiting period
- Employers required to inform employees of COBRA rights

Application of other federal law: HIPAA

- Prescribes permissible pre-existing condition exclusion periods, special enrollment periods, portability and renewability for employer groups of 2+
- Prohibits discrimination in health coverage eligibility and premiums based on health status, claims experience, etc.
- Applies to section 125 plans because HIPAA defines group health plans like COBRA
 - Therefore, to avoid tax law penalties, employers must be sure that insurers selling individual plans to employees under a cafeteria plan meet HIPAA standards

Application of other federal law: ERISA

- Federal Employee Retirement Income Security Act regulates private-sector employer-sponsored health plans
 - Clearly applies if employers contribute to employee insurance premiums
 - Also applies if employers sponsor a plan to which they don't contribute

Application of other federal law: ERISA

- Whether health insurance purchased individually via a cafeteria plan is an ERISA plan depends on extent of employer “endorsement” of individually purchased products under DOL regulation
- While not completely clear from written DOL policy or case law, it is possible to argue that
 - Health insurance purchased individually through a cafeteria plan is not an ERISA plan if employers do nothing more than payroll deductions
 - ERISA does not preempt a state requirement that employers offer cafeteria plans (DOL informally sanctioned the MA law)

Primary Cafeteria Plan Issues for Utah

- Uncertainty regarding final regulations for nondiscrimination requirements regarding HCEs and key employees
- HIPAA compliance – Utah's individual market is not HIPAA compliant
- ERISA
 - Whether individual policies become ERISA plans
 - Preemption challenge potential if Utah mandates employer cafeteria plans

Utah's Options

- H.B. 133 requires GOED to provide technical assistance to employers who choose to offer cafeteria plans
 - Model materials for establishing a cafeteria plan
 - Guidance on how to avoid the appearance of an employer endorsing a plan
- Current federal law does not hinder the state's ability to provide technical assistance for employers who offer group health plan and a cafeteria plan for the employee's share of premiums

Utah's Options

- Utah could require employers to establish cafeteria plans (P.O.P.), a move toward defined contribution
 - Utah would need to reform the individual market to comply with HIPAA (guaranteed issue and pre-existing condition)
 - Utah would need to change current insurance industry practice that requires employers to pay 50% of premiums for group plans

Utah's Options

- Utah could create a purchasing pool or exchange through which individuals could purchase health benefit plans
 - This helps distance employers from the plans to avoid ERISA “endorsement” arguments
 - Provides a method for employers to comply with IRS requirement that employers assure products bought under cafeteria plans meet HIPAA requirements